



– OCTOBER 2018 INSIGHTS BY THE CURVE TEAM –

HIGHLIGHTS

- The [RBA](#) left the cash rate on hold again in October and continues to see a gradual move towards achieving its forecasts over the medium [term](#).
- Falling house prices are yet to impact consumption or employment, but as price falls continue the pressure will build.
- The FOMC lifted rates again last month with the divergence of US Monetary policy with the rest of the globe gathering pace.
- Overall Australia's economy continues to hold up well in the face of growing headwinds both domestically and offshore.

RATES RECAP

- The [RBA](#) left the cash rate on hold again in September with the cash rate remaining at 1.50% since August 2016, a new record for stability.
- The [RBA](#) continues to emphasise the next move in the cash rate will likely be up not down; however, market pricing for a lift in the cash rate still points to no move until at least mid 2020.
- There is a growing chorus of commentators voicing their concerns over the outlook and confidence in the [RBA](#) central forecasts.
- Short end pressure in funding markets has stabilised over the past month with 3 and 6 month [BBSW](#) little changed.
- The Australian Dollar continues to fall, largely due to a stronger USD. The growing yield spread across the curve between the US and Australia isn't helping the AUD either.
- The US FOMC hiked rates as expected last month.
- Since then, further talk of hikes from [Fed](#) members and strong data has three more hikes priced in by next year and pushed longer [term](#) rates higher.

Key Market Moves			
	Latest	1 Month Ago	Change
Cash Rate	1.50	1.50	0.00
3M BBSW	1.92	1.95	-0.02
6M BBSW	2.11	2.15	-0.04
1 Year Swap	1.92	1.96	-0.04
3 Year Swap	2.12	2.08	0.04
5 Year Swap	2.50	2.41	0.09
3 Year Futures	2.09	2.03	0.06
10 Year Futures	2.75	2.55	0.20
AUD	0.71	0.72	-0.01
ASX 200	6188	6230	-42
US 2 year	2.87	2.65	0.22
US 10 year	3.19	2.90	0.29
US 30 year	3.35	3.08	0.28
USD Index	95.80	95.18	0.61
Dow Jones	26627	25975	652



MONETARY POLICY DIVERGENCE GATHERING PACE

Monetary policy divergence is a theme that has been simmering away for some time. Over the past few months it has been having a growing influence on global financial markets and the economic outlook.

The latest update from the FOMC at their September meeting suggests the divergence of monetary policy settings amongst the US and other major central banks is going to accelerate which will have a large impact on markets and the economic outlook over the months ahead.

At their September meeting the FOMC lifted the [Fed](#) Funds Rate as was widely expected heading into the meeting. They also updated their dot plots which charts expectations of all [Fed](#) governors and voting members on the board. It points to one more hike this year and potentially 3 more next year. Finally they revised up the planned run off of their balance sheet assets accumulated under its various quantitative easing programs.

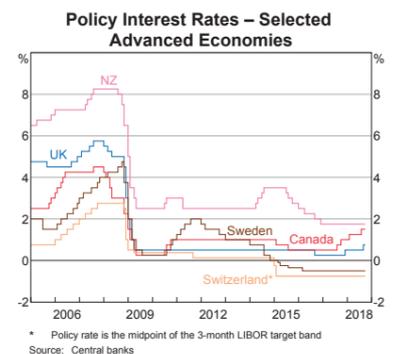
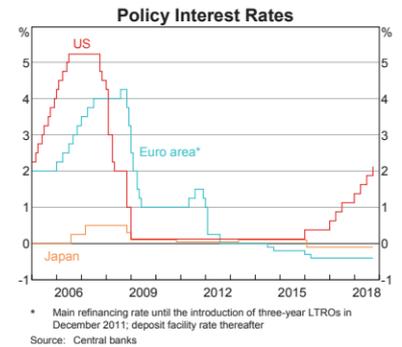
If we take a look around at some of the other major central banks, the outlook is vastly different.

- The ECB is aiming to wind up their quantitative easing program by the end of the year but has indicated it is unlikely to lift their overnight rate, which is still negative, until the back half of next year.
- The BoJ hasn't made any material change to policy in some time, despite letting longer [term bond](#) yields drift higher.
- The Bank of England and Bank of Canada are trying to normalise policy but the process has so far proved painfully slow.
- The RBNZ has been on hold of late and hasn't ruled out cutting rates if needed.
- The [RBA](#) is firmly on hold with the market not expecting any move next year.

The rhetoric since last months board meeting in light of another strong labour force report in the US has seen the [risk](#) increase that the [Fed](#) will have to do more not less over the medium [term](#).

A number of speakers including the FOMC Chair and Vice Chair have indicated the [Fed](#) Funds rate may have to not just go to neutral, but move beyond neutral should the strength of the US economy continue.

The impact of this growing divergence in monetary policy settings has had the most profound impact on the [bond](#) market in the US. [Bond](#) yields have broken higher across





the curve, especially in the longer end.

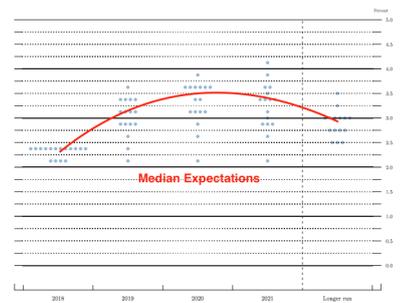
The move higher in longer [term](#) rates has been mirrored in a number of other countries, including our own, with similar moves of a smaller magnitude.

No only are interest rates rising but the growing divergence is putting upward pressure on the USD.

Rising interest rates and a stronger USD becomes problematic when globe has gorged itself on cheap USD denominated [debt](#). The problem becomes worse when the worlds biggest creditor, the US Treasury, is ramping up issuance of its down [debt](#), to fund a growing deficit, crowding out the rest of the market. The problem is then compounded when the Federal Reserve, who had been the biggest buyer of that [debt](#), intends buying less and less as it runs down its portfolio.

Signs of stress, especially in emerging markets, are starting to surface. When the cash rate in Argentina is 60%, inflation in Turkey has shot up to 25% and even the Indian Rupee is at a record low, things are looking troublesome. We are entering an interesting junction 10 years on from the Global Financial Crisis and the [risk](#) of negative consequences from the growing divergence in monetary policy settings globally is growing.

For release at 2:00 p.m., EDT, September 26, 2018
Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate.



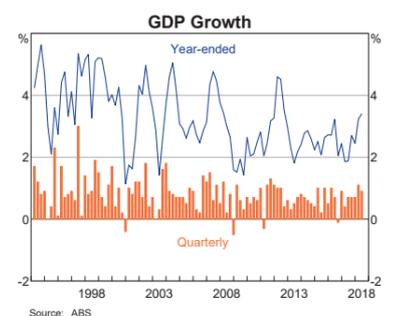
OUTLOOK FOR INTEREST RATES

Despite the developments over the past month, the [RBA](#) has remained steadfast in their outlook for the Australian economy and monetary policy.

The latest update from the [RBA](#) at their October meeting, where they left rates on hold, was their accompanying statement. They continue to point to a glass half full outlook.

Continued above trend growth and the steady downtrend in the unemployment rate have been enough to keep the [RBA](#) confident in their outlook despite the growing risks. They still expected that growth above 3% over the coming years will chip away at the slack in the labour force and eventually result in a pick up in wages.

They are acutely aware though that risks to the outlook are rising. I continue to point out that the ongoing trade wars pose a [risk](#) to the outlook. They also continue to highlight that consumption is the key [risk](#) to the economy but continue to downplay any significant impact stemming from the deterioration in the housing market.





The fact that they along with the Treasury have cautioned the government against taking a hardline approach to disciplining the banks after the release of the interim report from the Banking Royal Commission suggests they might be more worried than they are letting on.

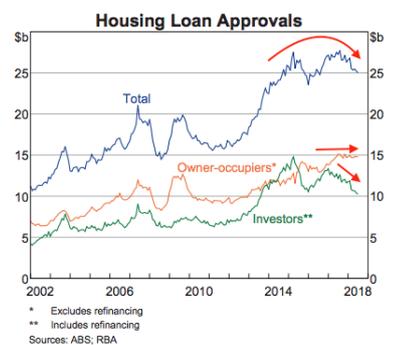
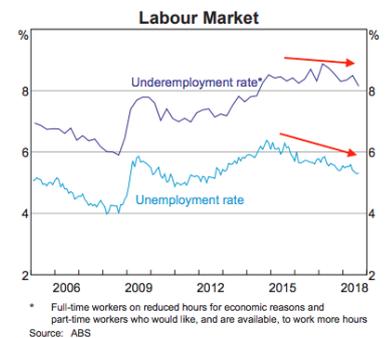
It has since been announced that the CEO's of the big four are being hauled before parliament to front the House of Representatives Standing Committee on Economics.

While the summons is being driven by the release of the interim report, the Chair of the committee Tim Wilson MP said *"these hearings will also be an important opportunity to follow up on unresolved issues from earlier hearings; and to consider how best to ensure appalling behaviour is not repeat without inhibiting the banks' essential contribution to grease our economy."*

Where the housing market goes will likely determine the outlook for monetary policy due to the flow on effects to consumption and employment. While there are a number of drivers at play driving the outlook for housing, credit is the key element at present.

Availability of credit and borrowing capacity has already been impacted by tighter lending standards and out of cycle rate increases from most lenders. The outlook for the housing market along with the broader economy and monetary policy will likely be affected should the provisioning of credit be further impacted.

For now the fall in house prices remains orderly and hasn't shown signs of impacting consumption or employment. The [RBA](#) is only likely to deviate from its current outlook if and when there is a material shift in these components.



AUSTRALIAN ECONOMIC HIGHLIGHTS

- **Growth** remained strong for the second straight quarter with the economy growing 0.9%. Upward revisions to the prior three quarters helped lift the annual rate to 3.4%.
- **CPI** was as expected in Q2 with headline inflation up 0.4% while core inflation increased 0.5%. The annual rate of headline inflation edged back into the [RBA](#)'s target band at 2.1% while the core annual rate was unchanged at 1.9%.
- The **Employment data** continues to post interesting outcomes. After the strange numbers last month, August saw total employment growth bounce back, jumping 44,000. Despite the bounce, the unemployment rate was little changed as the participation rate also jumped 0.2%.



- After a run of volatile months, the **ANZ job ads** posted back to back declines in August and September. The 0.7% fall in August was followed by a 0.8% fall in September. Ads are still up 4.7% compared to a year ago.
- The **Business confidence** index stabilised in September after softening in recent months and sits around its long run average. The **Business Conditions** Index remained stable at elevated levels with an improvement in the employment index offsetting slightly weaker trading conditions. One thing to keep an eye on is renewed deterioration in retail sector conditions.
- **Consumer confidence** fell for the second straight month in September with the 3% drop adding to the 2.3% fall the previous month. Long **term** economic expectations suffered the biggest fall while family finances are a significant ongoing concern for consumers.
- **Retail sales** picked up in August, rising 0.3% after starting the quarter unchanged in July. Food was flat for the month meaning the lift was driven by discretionary spending which is encouraging. Slow wage growth and falling house prices are likely to weigh on consumption over the months ahead.
- Investors continue to drive the slowdown in **Housing finance** which is down over 5% compared to a year ago. Stripping out refinancing from the data shows growth in owner occupier finance is down to 1% over the past year with total finance down 8.1%.
- Australia's **trade** balance continues to be a pillar of strength with another solid surplus recorded in August at \$1.6bn. Australia continues to benefit from elevated commodity prices, especially demand for coal, while LNG is also boosting exports.
- **Building approvals** collapsed in August posting a one month fall of 9.4% with approvals now down 27% from their late 2017 peak. The building approvals data along with the sharp fall in the construction PMI suggest the peak in construction on the back of the house price boom is now well behind us.



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